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## Islamic Finance for SMES

By Hussein ELASRAG <sup>†</sup>

**Abstract.** Small and Medium Enterprises (SMEs) make up the bulk of the economic tissue of the economy. In developing countries, they represent the majority of employment, including female employment. Investing in SMEs is a long-term and smart strategy, with sustainable returns that multiply across regions, countries and societies. SMEs constitute the overwhelming majority of firms. Globally, SMEs make up over 95% of all firms, account for approximately 50% of GDP and 60%–70% of total employment, when both formal and informal SMEs are taken into account. This amounts to between 420 million and 510 million SMEs, 310 million of which are in emerging markets. Promoting access to finance for SMEs has been on the global reform agenda since the global financial crisis. The purpose of this paper is to investigate the opportunities of development and growth as well as the main challenges to Islamic finance for SMEs. This paper will help to deepen understanding of the concepts of Islamic finance as well as SMEs. In addition to evaluate how Islamic financial institutions can support SMEs.

**Keywords:** Islamic economics, Islamic finance, Economic systems.

**JEL.** B10, B30, G20, K40, K20.

### 1. Introduction

Small and Medium Enterprises (SMEs) play a major role in most economies, particularly in developing countries. Formal SMEs contribute up to 45 percent of total employments and up to 33 percent of national income (GDP) in emerging economies. These numbers are significantly higher when informal SMEs are included. According to estimates, 600 million jobs will be needed in the next 15 years to absorb the growing global workforce, mainly in Asia and Sub-Saharan Africa. In emerging markets, most formal jobs are with SMEs, which also create 4 out of 5 new positions. However, access to finance is a key constraint to SME growth; without it, many SMEs languish and stagnate.

Despite the fact that SMEs account for a significant part of the country's economy and provide employment opportunities for the majority of people. SMEs are less likely to be able to secure bank loans than large firms; instead, they rely on internal or “personal” funds to launch and initially run their enterprises. Fifty percent of formal SMEs don't have access to formal credit. The financing gap is even larger when micro and informal enterprises are taken into account. Overall, approximately 70 percent of all MSMEs in emerging markets lack access to credit. While the gap varies considerably between regions, it's particularly wide in Africa and Asia. The current credit gap for formal SMEs is estimated to be US\$1.2

<sup>†</sup> INCEIF, Malaysia.



✉ [zubhasan@gmail.com](mailto:zubhasan@gmail.com)

trillion; the total credit gap for both formal and informal SMEs is as high as US\$2.6 trillion.<sup>i</sup>

A World Bank Group study suggests there are between 365-445 million micro, small and medium enterprises (MSMEs) in emerging markets: 25-30 million are formal SMEs; 55-70 million are formal micro enterprises; and 285-345 million are informal enterprises. Moving informal SMEs into the formal sector can have considerable advantages for the SME (for example, better access to credit and government services) and to the overall economy (for example, higher tax revenues, better regulation). Also, improving SMEs' access to finance and finding solutions to unlock sources of capital is crucial to enable this potentially dynamic sector to grow and provide the needed jobs.

Nevertheless, SMEs consistently cite lack of access to finance as a severe constraint. Often, the costs and risks of serving SMEs are perceived to be too high by banks. Because of information asymmetries and the high costs of gathering adequate information to assess the creditworthiness of typical SME borrowers, banks are usually reluctant to extend them unsecured credit, even at high interest rates. Subsequently, many SMEs with economically viable projects, but inadequate collateral, cannot obtain the most needed financing from traditional lenders. The International Finance Corporation (IFC) reports that top banks serving SMEs in non-OECD countries reach only 20% of formal micro enterprises and SMEs, and just 5% in sub-Saharan Africa. Underscoring the scale of problems with access to finance, the Asian Development Bank (ADB) estimates that there is a global gap of US\$ 1.9 trillion between the supply and need for trade finance alone. This gap widens especially at the 'lower end of the market', where almost half of SMEs requests for trade finance are estimated to be rejected, compared to only 7% for multinational corporations.

According to The World Bank estimates, approximately 70 percent of all MSMEs in emerging markets lack access to credit. While the gap varies considerably between regions, it's particularly wide in Africa and Asia. The current credit gap for formal SMEs is estimated to be US\$1.2 trillion; the total credit gap for both formal and informal SMEs is as high as US\$2.6 trillion. The lack of funding is one of the most important constraints faced by SMEs. Marketing and administrative barriers, the lack of an integrated accounting system, shortage of trained manpower, institutional constraints and government legislation are also limitations faced by the SMEs (Mumani, 2014). High interest rates and the lack of adequate collateral are the major barriers facing the SMEs where banks would usually finance large businesses and prefer to deal with them because of the low degree of risk and the ability of these businesses to provide the required guarantees.

According to several research studies in the last decade there are greater opportunities for development and growth of Islamic financial system because Muslim community is eager to take financial products and they are willing to spend their lives according to their religion. Islamic Finance is a promising solution to SMEs to meet the requirements of formal financing. And can prove particularly effective to facilitate access to finance for SMEs. Islamic finance has certain features which give it the potential to effectively support SME financing, and economic growth and development. According to a 2014 report by the World Bank's International Finance Corporation (IFC), there is a shortfall of some USD 13.2 billion in Islamic finance across nine surveyed Islamic countries. The IFC report notes that despite rising demand for Islamic financing among SMEs, only 36% of MENA region banks offer SME products, and a mere 17% subset of those offer Islamic options.

This has a chilling effect on SME financing, particularly in those countries where local SMEs won't consider non-Islamic finance. In Saudi Arabia, for

instance, IFC figures note that up to 90% of SMEs are only seeking Shariah-compliant banking services. When the net is widened to include Iraq, Pakistan, Yemen, Saudi Arabia, Jordan, Tunisia, Morocco, Lebanon and Egypt, around 35% of SMEs are dissuaded from borrowing due to a lack of Islamic banking options.<sup>ii</sup>

This is a gap that Islamic finance offerings can address. Islamic finance helps promote financial sector development and broadens financial inclusion. By expanding the range and reach of financial products, Islamic finance could help improve financial access and foster the inclusion of those deprived of financial services. Bank lending to SMEs seems to be tailor made for Islamic banking practises based around relationship lending as opposed to other more conventional forms of debt financing. A key competitive benefit of this approach is a pure cost advantage brought about by reduced monitoring costs. However, the nature of the contract may also provide opportunities for enhanced growth and an additional quality advantage based around the holding of collateral, greater managerial experience and reduced information asymmetries. Islamic banking and the use of Islamic financial products has increased significantly in recent years. A pure cost advantage should provide Islamic banks a foothold in the market for lending to SMEs. An additional quality advantage means that this advantage can be more intense in the sense that the market share of Islamic banks could increase dramatically in principle capturing the whole of the market. (Shaban, Duygun, & Fry, 2016)

Islamic finance emphasizes partnership-style financing, which could be useful in improving access to finance for the poor and small businesses. It could also help improve agricultural finance, contributing to improved food security. In this regard, Islamic finance can help meet the needs of those who don't currently use conventional finance because of religious reasons. Of the 1.6 billion Muslims in the world, only 14% use banks. It can help reduce the overall gap in access to finance, since non-Muslims aren't prohibited from using Islamic financial services.<sup>iii</sup> However, the Islamic financial system, operating alongside the conventional sector, is also exposed to broadly the same systemic risk factors and volatilities as its conventional counterpart, despite its sustained growth momentum. The various sections of this chapter further analyze the growth momentum and structural shifts of the Islamic finance industry while assessing financial stability aspects in light of the evolving global macroeconomic and financial conditions. The Islamic finance industry has expanded rapidly during the last decade, with annual growth rates of over 15%. In many majority Muslim countries, Islamic banking assets have been growing faster than conventional banking assets.<sup>iv</sup> Islamic finance's underpinning principles of promoting participation, equity, property rights and ethics are all "universal values". And yet, despite these important benefits and the clear potential, there is still a long way to go to fulfil the maximum potential of Islamic finance. Today, it represents less than 1 percent of global financial assets and is still very much concentrated in a few markets. So there is clearly room to grow, especially given that the features of Islamic products can appeal to a much wider group.<sup>v</sup>

In accordance with these principles, Islamic finance has developed specific financing products (Léon & Weill, 2016). First, two core financing products are partnership contracts between the lender and the borrower based on the profit-and-loss-sharing principle: musharaka, and mudaraba. A mudaraba contract is based on the fact that the lender provides the capital and the borrower provides the effort and know-how. Profits are shared between both parties, whereas losses are borne solely by the lender. Under a musharaka contract, profits and losses are shared between the lender and the borrower because all parties have made capital contributions.

Second, murabaha is a mark-up sale based on the fact that the lender buys a good and sells it to the customer in exchange for a price that includes the original cost and a specified margin. It must be stressed that the price can be paid in several instalments, which makes murabaha quite similar to a loan with interest from the borrower's perspective. There are however differences between both forms of financing. On the one hand, there is no interest in the sense that the return applies to the sale of a good and not the sale of money. On the other hand, charging a penalty for default is prohibited. Third, ijara mirrors the conventional leasing contract in Islamic finance. The lender buys a good and leases it to the customer for a given period and a given rent. Hence the bank does not make money from money in compliance with Islamic law as it converts money into tangible assets to make the transaction. While Islamic Finance is not new and has been practiced for centuries around the world, it has gained in popularity of late. Total Islamic finance assets are estimated at around \$2 trillion, practically a ten-fold increase from a decade ago, and outperforming the growth of conventional finance in many places. It is easy to see the appeal of Islamic Finance. Here are just two:<sup>vi</sup>

First, Inclusivity: Islamic finance has the potential to contribute to higher and more inclusive economic growth by increasing access of banking services to underserved populations. To this day, a large segment of the Muslim population—who are a primary, but not the only, market for Islamic finance around the world—remain financially underserved, with only one-quarter of adults having access to bank accounts.

In addition, Islamic finance's risk-sharing features and the strong link of credit to collateral means that it is well-suited for Small and Medium-Sized Enterprise (SME) and startup financing—which we know can promote inclusive growth. For the same reason, Islamic finance has shown its value in infrastructure investment, which can spark productivity gains and catalyze high value-added growth. Second, Stability: Islamic finance has, in principle, the potential to promote financial stability because its risk-sharing feature reduces leverage and its financing is asset-backed and thus fully collateralized. In addition, besides deposits, Islamic banks offer profit-sharing and loss-bearing accounts that can help mitigate losses and contagion in the event of banking sector distress. This leads, *de facto*, to higher total loss-absorbing capital, one of the key objectives of the new global regulatory reform. Since the SMEs are important for the economy, the Islamic banks and Islamic financial institutions must play a significant role in financing these businesses. Supporting SMEs are one of the objectives of religious institutions, thus the most important goal of Islamic banks and Islamic financial institutions is to contribute to the economic and social development of the society. This study aims to analyze the appropriateness of the Islamic financial system for SME finance. From the smallest rural villages in Bangladesh to the large, bustling metropolitan centres of Cairo or Istanbul, small and medium enterprises (SMEs) are the lifeblood of Islamic communities around the world, keeping local economies humming. But even though SMEs play such an important role in the global economy, they have historically struggled to gain reliable access to capital. The IFC Enterprise Finance Gap Database tells us that between 55% and 68% of SMEs in developing countries are either financially underserved or not served at all.<sup>vii</sup>

These high numbers translate into significant lost opportunities to develop viable businesses. Even in the G20 countries, it is estimated that SMEs face a financing gap of \$1.3 trillion. According to the ISFB report, most of the sample Islamic banking jurisdictions are characterized as markets where businesses normally rely on the banking sector to meet their financing needs, particularly in the South Asia and Middle East regions, where corporate bond markets are

relatively underdeveloped and have only begun to expand in recent years. As a result, the sample Islamic banking industry's business financing exposure generally is concentrated in private-sector businesses and may include funding their working capital needs, project financing and capital financing. Among the key Islamic banking markets with higher financing concentration in the private sector are Jordan (48%), Bahrain (63%), Kuwait (65%), Pakistan (69%), Bangladesh (78%) and Turkey (78%). These markets also host a large number of small and medium enterprises that rely on the bank funding channels for their financing needs, since tapping the bond markets is not feasible for SMEs due to the higher costs and lengthy processes involved in issuing debt instruments. Although insufficient data are available to differentiate between sample Islamic banks' exposure to large corporations and SMEs, the risk concentration in the private sector could be building vulnerability in the Islamic banking sector should the general macroeconomic downturn worsen in the global economy, leading to weaker growth in emerging markets ([Islamic Financial Services Board, May 2015](#)).

The reasons why banks and financial intermediaries have failed and may continue to fail in the pricing of risks and hence in optimal lending to firms, and the possible regulatory remedies for this, is an issue that certainly requires further investigation. This paper will try to give hints and insights into this, and to present some of the Islamic financial instruments that are being supplied by the market for the financing of SMEs in particular.

## 2. Understanding SMEs

The influence of small and medium-sized enterprises (SMEs) on the structure, performance and future prospects of a nation's economy is the subject of increasing interest among policymakers at the national, regional and global level. This reflects the fact that in most countries, SMEs constitute the overwhelming majority of firms and are major sources of employment. Add to this evidence that SMEs, and in particular young small firms, have been net contributors to employment growth since the 2008 financial crisis, and the rationale behind the greater focus on SME performance becomes clear. ([International Trade Centre, 2015](#))

Small and medium-sized enterprises have positive contributions in providing and maintaining balanced economic and social development. They also play an important role in decreasing the level of unemployment and creating new employment opportunities and with their flexible production structure they can follow the changes in the market conditions more effectively. SMEs make crucial contributions to job creation and income generation; they account for two-thirds of all jobs worldwide. ([International Labour Office, 2015](#)).

SMEs make up the majority of firms in the world and are responsible for a large portion of its employment. According to some estimates, SMEs constitute up to 95% of the world's firms and between 80-90% of total employment in the developing world. However, not all that employment takes place within formal establishments. An estimate by ILO suggests: "...there are 420 to 510 million SMEs worldwide, of which 9 per cent are formal SMEs (excluding micro-enterprises)" ([Navas-Alemán & Guerrero, 2016](#)). The constraints to SME growth – as perceived by business owners – is a relatively well-researched area. The three biggest constraints across countries are access to finance, access to electricity and competition from informal enterprises. However, constraints vary according to countries' level of development as well as by region. ([International Labour Office, 2015](#)).

The term "SME" encompasses a broad spectrum of definitions. Different organizations and countries set their own guidelines for defining SMEs, often



based on headcount, sales or assets. SMEs come in many different shapes and sizes; however, in today's complex business environment they may have close financial, operational or governance relationships with other enterprises. These relationships often make it difficult to precisely draw the line between an SME and a larger enterprise.

### *2.1. SMEs Definitions*

The term 'SME' encompasses a broad range of definitions, which differ according to factors such as country, geographic region, level of development and business culture. Even within countries, definitions may vary or be non-existent. In addition, the definition itself is often linked to national support programmes and other regulations, making the adoption of a single definition difficult. Adding to the plethora of country definitions for SMEs are those created by international organizations and nongovernmental organizations (NGOs). The specific needs and environment of their project portfolios often drive such definitions. Multiple criteria used to define SMEs, such as the number of workers, asset size, annual sales, or annual production, and so on. This probably reflects the firm size distribution of the regions in which the latter institutions operate, and thus the level of economic development. According to (Abdelhamid & El Mahdi, 2003; Elasrag, 2010), three main quantitative parameters are commonly used in the SMEs definitions. In addition to these quantitative parameters, a few countries have added qualitative criteria into their definitions of the M/SME sector. It is important to cover both the quantitative aspects and the qualitative measures.

SMEs are the engine of the European economy. They drive job creation and economic growth and ensure social stability. In 2013, over 21 million SMEs provided 88.8 million jobs throughout the EU. Nine out of every 10 enterprises is an SME, and SMEs generate two out of every three jobs. SMEs also stimulate an entrepreneurial spirit and innovation throughout the EU and are thus crucial for fostering competitiveness and employment (European Commission, 2015).

### *2.2. SMEs distribution in various parts of the World*

In the European Union (EU), SMEs constitute 99.8% of all businesses, 66.9% of employment and 58.1% of value added. This translates into 88.8 million jobs and over €3.6 trillion in value added, with SME exporters contributing 34% of total EU exports, or €1.54 trillion (Cernat, López, & T-Figueras, 2014; International Trade Centre, 2015).

In the United States of America, SMEs account for 99% of all firms, employ 50% of the private sector workforce, account for over half of non-farm gross domestic product (GDP), and represent 34% of total export revenue (International Trade Centre, 2015; United States International Trade Commission, 2014). Evidence for 10 South-East Asian countries shows that, on average, SMEs account for 98% of all enterprises and employ 66% of the labour force. These SMEs contribute approximately 38% of GDP and about 30% of total export value.

In China, the world's biggest exporter, SMEs represent 41.5% of total exports by value, clearly underlining their importance to the Chinese economy. In Gulf Cooperation Council (GCC) countries, SMEs are estimated to account for 22% of GDP, a relatively low share when compared with other parts of the world. This trend extends to employment, with SMEs accounting for only about 40% of employment (International Trade Centre, 2015).

In Latin America and the Caribbean (LAC) region, SMEs account for 99% of firms and 67% of employment. However, their contribution to GDP is relatively low. This is because in LAC countries, large firms are six times more productive than SMEs, compared with 2.4 times in countries belonging to the Organisation for Economic Co-operation and Development (OECD). If SMEs in LAC countries

were to narrow this productivity difference to levels found in the developed world, they could achieve massive economic gains. While few pan-African SME statistics are available, SMEs in Africa are known to dominate the means of production to a greater extent than in other regions. For example, in Ghana, SMEs represent 92% of Ghanaian businesses and contribute about 70% of GDP (International Trade Centre (ITC), 2015).

**Table 1.** *Estimated number of SMEs worldwide by region*

Region	No. of SMEs in region (million)	Percentage of total SMEs worldwide	Total formal SMEs (million)
East Asia	170–205	44–46	11–14
Latin America	47–57	10–12	3–4
Sub-Saharan Africa	36–44	8–10	3–5
Central Asia and Eastern Europe	18–22	3–5	2–4
South Asia	75–90	16–20	2–3
Middle East and North Africa	19–23	4–6	1–3
High-income OECD countries	56–67	12–14	11–14
Total	420–510	100	36–44
Total excluding high-income OECD countries	365–445	80–95	25–30

**Source:** International Labour Office. (2015). Small and medium-sized enterprises and decent and productive employment creation Retrieved from Geneva, Switzerland.

### 2.3. SMEs and access to finance

While SMEs have this level of socioeconomic significance, their relevance and impact are not proportionally met with support mechanisms and channels that would facilitate the growth of existing SMEs, as well as the establishment of new ones, and which would increase their economic and social magnitude even further. SMEs across the world -especially in developing countries- are facing challenges that are, to a large extent, similar in nature and include limited access to finance, high transaction costs, the lack of skilled human resources, unfavourable legal and regulatory environments, limited access to technology, and inadequate access to markets. The major challenge faced by SMEs, however, is access to finance. According to the IFC Finance Gap Database, the total financing gap for micro, small, and medium enterprises (MSMEs) in developing countries is estimated to be \$ 2.4 trillion: of this total, a gap of about \$1.3 trillion exists in G20 countries covered within the IFC Finance Gap Database) (World Bank Group & Islamic Development Bank, 2015).

**Table 2.** *MSME Credit Gap in Selected G20 Countries*

Country	Number of enterprises, thousands	Total credit gap, \$billion	Access to finance as major/severe barrier (percent of MSMEs)
Argentina	2,133	67	34
Brazil	16,030	237	42
China	103,548	338	18
India	49,634	140	23
Indonesia	41,116	28	15
Korea, Rep.	4,644	114	17
Russian Federation	3,605	50	44
Saudi Arabia	1,843	237	42
South Africa	2,213	13	15
Turkey	4,120	73	20
Total	228,886	1,297	

**Source:** World Bank Group, & Islamic Development Bank. (2015). Leveraging Islamic Finance for Small and Medium Enterprises (SMEs).

Access to finance is therefore a global challenge for both developed and developing countries and needs to be addressed more thoroughly by policy makers, the private sector, researchers, and development agencies, especially with regard to creating prosperity and opportunities. Special focus should be directed to entrepreneurs, who are collectively capable through innovative and high-growth

start-ups of contributing significantly to the economic growth, job creation, and welfare of their respective countries and regions. This enormous financing gap poses great challenges that need to be met through innovative and diverse financial product offerings, improving access to finance for SMEs on a global scale ([World Bank Group & Islamic Development Bank, 2015](#)).

According to the OECD SME loan growth between 2013 and 2014 picked up in the majority of participating countries. The share of SME loans to overall corporate lending also rose considerably in 2014. This development was driven largely by better macro-economic and financial conditions in most developed economies. The downward trend in bankruptcies in the majority of participating countries further underscores the recent improvements in the general environment for SMEs. Credit conditions also loosened, while interest rates have fallen sharply in recent years in almost every participating country ([OECD, 2016](#)).

Nevertheless, SME access to bank credit will remain a concern in the years to come. In spite of recent improvements, access to finance remains problematic in many economies, and many SMEs continue to face credit constraints. Although credit conditions have generally improved, they remain tight on average. Furthermore, many financial institutions continue to deleverage and, due to tightened regulatory requirements, this will likely impact small businesses disproportionately.

Credit conditions generally eased in 2014, but remain overall challenging for many SMEs. Thanks to an accommodative monetary policy in most regions of the world, SME interest rates declined in 2014, thereby continuing the downward trend observed in recent years. Demand-side surveys suggest a continued easing of credit conditions in a majority of participating countries, including a decline in loan rejection rates. Interest rates also declined significantly between 2012 and 2014, for example by 40% in Sweden, by 21% in Italy, and by 20% in Korea. At the same time, large cross-country differences persist, with credit standards remaining comparatively tight and interest rates relatively high in the economies most affected by the financial and ensuing sovereign debt crisis. This also holds true for several emerging economies with relatively high inflation rates, such as Colombia or the Russian Federation, where interest rates were still around four times higher than the median value of participating countries ([OECD, 2016](#)).

### 3. Understanding Islamic finance

Islamic finance is the only example of a financial system directly based on the ethical precepts of a major religion, providing not only investment guidelines but also a set of unique investment and financing products.” Islamic finance is based on Shari’ah, the Islamic law that provides guidelines for multiple aspects of Muslim life, including religion, politics, economics, banking, business and aspects of the legal system. What Shari’ah compliant financing (SCF) seeks to do is to shape financial practices and accompanying legal instruments that conform to Islamic law. Major financial principles of Shari’ah include a ban on interest, a ban on uncertainty, adherence to risk-sharing and profit-sharing, promotion of ethical investments that enhance society and do not violate practices banned in the Qur’an and tangible asset-backing ([Elasrag, 2011](#)).

Money, according to Islamic teachings is a measure of value, not a commodity. Debt is a relationship in which risk and responsibility are shared by all parties to a contract. Money must be put to practical use in creating real value for the participants of the transaction. It must be used to create, and not be a commodity in on and of itself. It is because of this that the perception of hoarding capital, and the

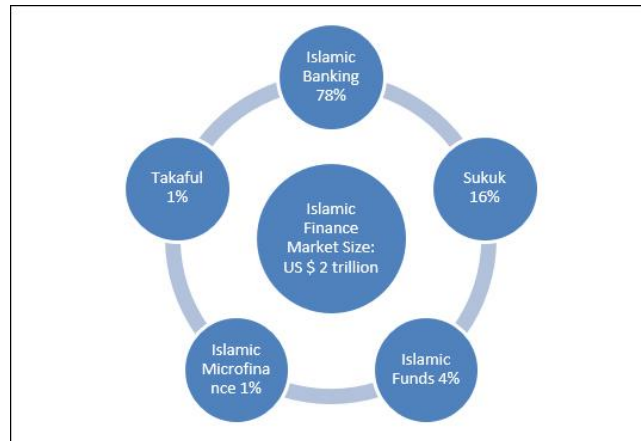


earning of a passive return on capital keyed to the passage of time, -i.e. interest – is prohibited. In short, money must not be made from money.

The establishment of modern Islamic financial institutions started three decades ago. Currently, there are at least 70 countries that have some form of Islamic financial services; almost all major multinational banks are offering these services. The underlying financial principles in Islamic finance have remained unchanged historically since their development over 1,400 years ago. Financial products must be certified as Sharia compliant by an expert in Islamic law. Certification requires that the transaction adheres to a number of key principles that include: (Chapra, 2011) i- Backing by a tangible asset, usufruct or services, so as to avoid ‘speculation’ (gharar). Prohibition of interest payments (riba). ii- Risk to be shared amongst participants. iii- Limitations on sale of financial assets and their use as collateral. iv- Prohibition of finance for activities deemed incompatible with sharia law (haram), such as alcohol, conventional financial services, gambling and tobacco.

Modern Islamic finance emerged in the mid-1970s with the founding of the first large Islamic banks. Development initially occurred through marketing of a steadily expanding supply of Sharia compliant financial instruments. This supply-driven model contributed to relatively slow growth until the mid-1990s, since when demand has increasingly driven the development of Islamic financial instruments. Rising awareness and demand for Islamic products, along with supportive government policies and growing sophistication of financial institutions, have together raised the rate of growth. Two developments have been critical to the expansion of Islamic financial markets. In 1998, the so-called “Dow Jones Islamic Indexes fatwa” played a transformative role because it opened the door to a limited degree of “permissible impurity” in financial transactions and institutionalized a notion of cleansing and purification whereby small amounts of impermissible interest income could be cleansed or purified by donation to charity. In turn, this led to a series of equity investment tests that could be used to evaluate potential investments for Shari'ah compliance. A second critical innovation was the introduction of sukuk – a Shari'ah compliant substitute for bonds – where capital protection is achieved not as a loan but as a binding agreement by the issuer to repurchase certain assets over a period of time.

Sukuk has now become one of the backbones of Islamic capital markets and has enabled the rapid growth of Islamic financial transactions. While the Islamic finance industry represents a fraction of the global finance market, it has grown at double-digit rates in recent years. By some estimates, total assets held globally under Islamic finance reached \$2 trillion in 2015. Islamic banks have appeared to be more resilient than conventional banks to the immediate effects of the international financial crisis and global economic downturn. Some analysts have attributed this to Islamic banks’ avoidance of speculative activities. However, the Islamic finance industry has not been completely immune to the general decline in demand and investor uncertainty.



Source: Muhammad Zubair Mughal Funding Sources for Islamic Microfinance Institutions. [\[Retrieved from\]](#).

Shari'ah compliant finance has become an accepted and vibrant element in international financial transactions. It offers a fresh opportunity to emphasize the moral and ethical aspects of business and finance that reaches beyond the Arab and Islamic worlds to prompt a re-examination of the core values underlying all global financial transactions -making available the financial resources needed to develop the human capital that will sustain economic and social progress. The main principles of Islamic finance include: i- The prohibition of taking or receiving interest; ii- Capital must have a social and ethical purpose beyond pure, unfettered return; iii- Investments in businesses dealing with alcohol, gambling, drugs or anything else that the Shari'ah considers unlawful are deemed undesirable and prohibited; iv- A prohibition on transactions involving maysir (speculation or gambling); and v- A prohibition on gharar, or uncertainty about the subject- matter and terms of contracts- this includes a prohibition on selling something that one does not own.

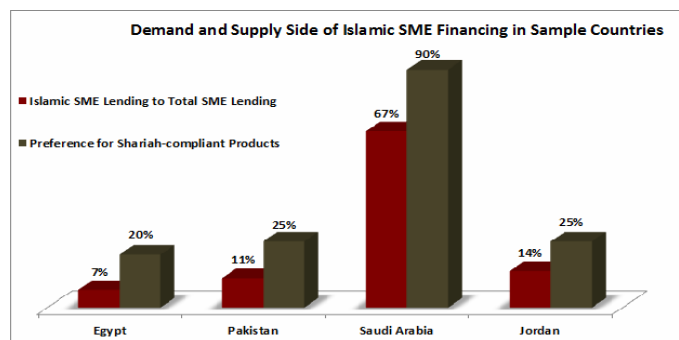
Because of the restriction on interest-earning investments, Islamic banks must obtain their earnings through profit-sharing investments or fee-based returns. When loans are given for business purposes, the lender, if he wants to make a legitimate gain under the Shari'ah, should take part in the risk. If a lender does not take part in the risk, his receipt of any gain over the amount loaned is classed as interest. Islamic financial institutions also have the flexibility to engage in leasing transactions, including leasing transactions with purchase options. It may be asked why non-Muslims would agree to use Islamic finance structures. The principal answer is that Islamic finance provides an opportunity to tap into the significant funds of Islamic investors seeking Shari'ah compliant investments. In addition, Islamic finance can be combined with conventional funding sources and export credit agency (ECA) support.

### *3.1. Islamic financing techniques for SMEs*

SMEs across the world, especially in developing countries are facing various challenges, and access to formal finance is one of the main obstacles that they face. According to the IFC, study, close to 45 to 55 percent of the formal SMEs in the emerging markets do not have access to formal institutional loans or overdrafts despite a need for one (Malaysia International Islamic Financial Centre, February 2016). The finance gap is bigger when considering the micro and informal enterprises - 65-72 percent of all MSMEs in emerging market lack access to credit. In addition, about 55-68 percent of SMEs in developing countries are either financially underserved or not served at all, resulting in lost opportunity to realize their full potential (World Bank Group & Islamic Development Bank, 2015).

Access to finance is a global challenge that needs to be addressed more thoroughly by various related bodies and agencies. The global challenge can be met through innovative and diverse financial product offerings. In terms of innovative and diverse source of financing for SMEs and MSMEs, one possibility is to identify the strength and potential of participatory finance such as Islamic finance. Various socio-economic tools that Islamic finance can further tap into include zakat, waqf and qard al-hassan (benevolent loan) alongside socio-economic financial instruments that are designed to provide financial assistance to the poor such as Shari'ah-compliant small and medium enterprises ([Malaysia International Islamic Financial Centre, 2016](#)).

The demand and supply for Islamic finance and Islamic SME financing specifically must be analyzed from various perspectives to put it into context with the factors related to supporting innovative financial solutions that tackle financial inclusion, while serving a growing Muslim population and their Shari'ah preferences. Shari'ah-compliant SME loans (see figure 2), for instance, represent only 7 percent of the total loans in Egypt, whereas the demand for Islamic financial products is about 20 percent. Saudi Arabia has the smallest gap between demand (90 percent) and supply (67 percent), due to the large number of Islamic banks in Saudi Arabia. It is estimated that about 32 percent of SMEs across the MENA region are totally excluded from access to finance, mainly because of the lack of Shari'ah-compliant products. The “risk-averse” approach of banks and specifically Islamic banks has led to a narrow product range offered to SMEs in these countries.



**Figure 2:** Demand and Supply Side of Islamic SME Financing

**Source:** World Bank Group, & Islamic Development Bank. (2015). Leveraging Islamic Finance for Small and Medium Enterprises (SMEs).

A significant share of SMEs are seeking exclusively Islamic banking products to meet their financing needs and would not opt for conventional banking products due to the lack of Shari'ah-compliance. The demand problem is further magnified when assessed from the supply side; the average share of SME lending in the portfolios of MENA banks is only 7.6 percent, as lending activities are mainly focused on large corporate customers and government bonds ([World Bank Group & Islamic Development Bank, 2015](#)). Irrespective of how Islamic finance is labelled, based on the core values of promoting economic development through a portfolio of asset-based and equity-based financing solutions, a clear financing gap for SMEs can be tackled and served through Islamic banking and nonbanking financial services.

### 3.2. Obstacles faced by banks in SME financing

According to the IFC study, there are many obstacles facing banks in the financing of small and medium enterprises ([IFC, 2014](#)).

1. SMEs lack managerial capabilities to manage businesses effectively. This leads to an inefficient operations structure, weak financial reporting, and unviable operations (high debt). In addition, SMEs mostly operate in the informal sector. Hence, banks are reluctant to lend to SMEs and perceive them as risky investments.

2. Although already highlighted in several IFC studies, it is still worth noting significant factors that affect the supply of finance to the SME sector. Factors include SME-specific problems (lack of a proper business structure), as well as issues faced by banks in servicing the SME sector (lack of capacity to lend to SMEs). Problems restricting access to finance are unique to each country, but several common themes underline these problems.

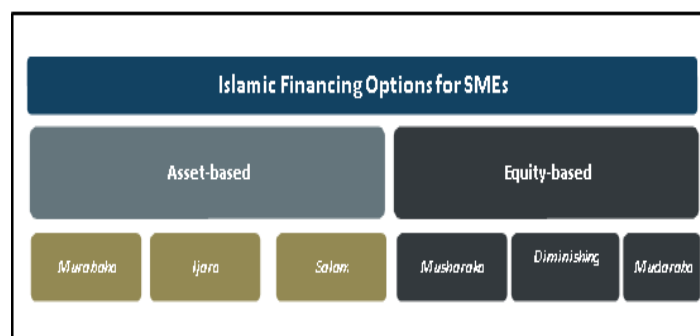
3. Multilateral agencies should, therefore, partner with government and private stakeholders to train SMEs on efficient management of businesses (e.g., IFC Business Edge). This would increase their viability in the long run and make them more palatable for bank lending.

4. Most banks lack capabilities to lend to the SME sector. This could include inadequate processes, lack of SME-specific products (especially Islamic products), untrained staff, and insufficient outreach. The significant risks involved together with high costs of transactions/servicing the SME customer also deter banks from targeting the SME sector. Because of these institutional gaps, banks tend to focus on emerging and medium-sized businesses and corporations, which are safer investments than SMEs, and banks already possess the capabilities to lend to these businesses effectively.

5. Multilateral institutions and other agencies need to assist banks to enhance institutional capabilities through staff training and introducing SME-specific products. Banks would then be able to screen SMEs better for lending, thus increasing credit flow to them.

6. Lack of information on SMEs is another problem faced by banks across countries. The lack of a credit bureau with adequate information on SMEs is a significant hurdle preventing banks from lending to them. The problem presents a significant opportunity to develop an exhaustive database on SMEs, which would plug information gaps and lead to increased supply of finance to the SME sector.

Islamic finance, as an alternative and ethical financing method, directs funding to impact-oriented real economic activities; it thus utilizes economic and financial resources to satisfy the material and social needs of all members of the community—including SMEs and innovative start-ups. The main foundations of Islamic financial products are its asset-based transaction nature, together with its equity-based nature of sharing risk and profits. Each of these financing categories has a fundamental role to play in increasing the financial inclusion of SMEs and innovative start-ups, as well as attracting potential capital from Islamic capital providers and sources (World Bank Group & Islamic Development Bank, 2015).



**Figure 3.** *Islamic Financing Options for SMEs*

### 3.3. *Islamic financing poptions for SMEs*

Islamic markets offer different instruments to satisfy providers and users of funds in a variety of ways: sales, trade financing, and investment. Basic instruments include cost-plus financing (murabaha), profit-sharing (mudaraba), leasing (ijara), partnership (musharaka), and forward sale (bay' salam), Deferred-payment sale (bay' mu'ajjal) and deferred-delivery sale (bay'salam) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in instalments, provided there is no extra charge for the delay. A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market (Iqbal, 1997).

These instruments serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets. There are several methods of Islamic financing. However, in the world of commercial financing and more particularly, project financing, certain methods are more commonly encountered than others. These are set out below.

## 4. Key elemens required to unlock the full potential of Islamic finance for SMEs

What are the key elements required to unlock the full potential of Islamic finance in an effective and prudent way? I see several priorities:<sup>viii</sup>

### 4.1. *Creating a enabling environment*

The first priority is to level the playing field and create an enabling environment for Islamic finance to develop, while being mindful of risks. This means adapting financial regulations that take into account the defining features of Islamic finance and do not disadvantage Islamic banks. For example, capital requirements for banks should be adapted to account for Islamic finance's risk-and-profit sharing model-which allows for some loss-bearing by investors and reduces risk weights applied to equity-like financing.

Leveling the playing field also means harmonizing the tax treatment of Islamic finance products with similar conventional contracts. Income tax systems typically recognize interest gains on debt instruments as a deductible expense. This debt bias puts Islamic finance at a competitive disadvantage and discourages risk-shared financing. Some countries can already remedy this disadvantage under their existing tax systems, but others still have to review their tax legislation.

The need for greater consistency in the application of regulation and supervision to Islamic banks and governance across jurisdictions. Islamic standard setters - including the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions- have done an impressive job in establishing the rules of the road. In so doing, they have cultivated closer cooperation with conventional financial standard setters, which bodes well for global financial stability. More needs to be done to enforce these rules. The current standards are not being applied consistently across countries. This could stifle the development of Islamic finance, or encourage its growth in a manner that creates systemic vulnerabilities.

### 4.2. *Developing the industry and markets*

The second priority for policymakers is to further develop the industry and markets. Many countries could encourage further improvements in Islamic banking to boost financing for small- and medium-sized enterprises. For instance, information about the creditworthiness of SMEs needs to be strengthened,



including collateral availability. More efforts are needed to train well-qualified staff, who can help meet the high demand for Islamic finance products. And Islamic banks need to bolster their risk management capacity for SME lending.

Some of these initiatives will be led by the industry itself. Others will also need to play their roles—with regulators ensuring that adequate credit risk systems are in place, with development banks partnering with Islamic banks for SME financing and capacity building, and with governments fostering financial education and literacy. In addition to strengthening the industry, many countries could further develop Islamic financial markets. Think of the growth potential of Sukuk. Over the past decade, total outstanding Sukuk assets have seen a ten-fold increase to about \$300 billion. Most of these assets remain concentrated in the Gulf States and Malaysia. But interest has been growing in other parts of the world. Luxembourg, Hong Kong, South Africa, and the United Kingdom are among a growing number of other countries that have issued Sukuk bonds in recent years.

For example, more regular sovereign issuance is needed at different maturities to help establish benchmarks and develop secondary markets. Sovereign Sukuk plans need to be embedded in governments' debt management strategies. And the market needs to be supported by strong legal and regulatory frameworks. The latter would help address persistent uncertainty over investors' rights.

Many countries also need to develop money and interbank markets for Shari'ah-compliant instruments to help Islamic banks manage liquidity needs more effectively. An underdeveloped market forces Islamic banks to hold excess liquidity buffers. It also limits central banks in the conduct of their monetary policies, particularly in countries with large Islamic banking systems.

#### *4.3. Ensuring financial stability*

The third priority for policymakers is to further strengthen regulation and supervision to ensure financial stability. The need for greater international consistency in the application of regulatory and supervisory standards. This is essential not only because it helps level the playing field, but because it helps manage the specific risks associated with Islamic finance and prevents regulatory arbitrage. At the same time, we should ensure that Islamic financial institutions are not under-regulated or over-regulated, and that standards are adapted to take into account the specific features of Islamic products.

The gradual implementation of the Basel capital and liquidity requirements adapted for the features of Islamic finance will be key. This transition may not be easy for Islamic banks, particularly regarding liquidity. But it can be seen as an opportunity for development of new instruments and markets, and will need to be completed to ensure the resilience of national banking systems.

Already Islamic finance is considered systemically important in 10 countries, where it accounts for more than 15 percent of total financial assets. Of course, with increased clout comes increased responsibility on the part of Islamic banks -and a growing need for oversight. Financial safety nets-including deposit insurance and lender-of-last-resort facilities- also need to evolve to take into account the specific features of Islamic finance. Without these upgrades, countries may not have the tools to adequately respond to shocks to individual financial institutions. Nor would they have the capacity to prevent spillovers to the conventional banking system.

### **5. Strategic operational adjustments to target SMEs**

In order to capitalize on the funding and depository potential, Islamic banks need to look beyond the conventional 'one-size-fits-all' approach and provide SMEs with customized value additions, much akin to what many conventional

banks are now increasingly offering. The required competency framework is highlighted below where banks would need to acquire the required proficiencies for building and managing a successful “Islamic SME Banking” business:<sup>ix</sup>

### *5.1. Strategy and Segmentation*

A dedicated Islamic SME Banking strategy and business model is critical: Banks would need to adopt specific market segmentation approaches to be able to better understand the market dynamics, quantify the business opportunity, build appropriate propositions, and deploy the optimal operating model. Customers’ lack of awareness of banks and institutions (especially Islamic ones) that offer SME finance propositions creates a huge supply-side gap. Islamic banks can fill this gap by effectively branding and marketing Islamic propositions for SMEs as well as by creating separate business units/divisions with specialized SME strategies.

### *5.2. Products and Services*

**Borrowing solutions:** Traditional products may now allow banks to acquire the required scale for a profitable Islamic SME portfolio. Hence, it would be necessary to tailor existing corporate and retail banking products and, more importantly, build product programs and portfolio approaches. **Offering non-borrowing services:** Islamic banks should broaden product and service offerings by providing non-borrowing services such as cash management, payroll management, payments, collections, and trade finance solutions. Internet banking and mobile banking services should also be considered along with provisions for SME-specific debit cards with daily limits.

### *5.3. Sales and Delivery*

**Introduction of new Islamic SME banking models:** Islamic banks should use new SME banking models to target SMEs. The use of mobile banking to enhance financial inclusion and reduce the cost of administering an account could be a good initial step. The use of banking correspondents to ensure last-mile connectivity of banking services could also be a focus area. Islamic banks could establish SME-specific branches in key SME clusters. Moreover, Islamic banks need to streamline or realign their transaction execution processes to make the execution of Islamic transactions easier for SMEs.

### *5.4. Advisory Services*

**Focus on advisory services:** A majority of SMEs do not have sufficient knowledge about finance and management, business skills (such as financial modeling, future planning, and forecasting) and information related to government rules and regulations that impact their functioning. This knowledge deficit prevents SMEs from evolving into larger and more sustainable enterprises. Islamic banks should provide SMEs with advisory services to aid and facilitate growth.

### *5.5. Organization and Systems*

**Better training for SME professionals:** There is a shortage of staff knowledgeable about Shariah-compliant products across financial institutions due to the inadequate amount of time and effort spent on training them. To rectify this, financial institutions need to incorporate better training procedures into their organizational frameworks. Investing in employee training would allow Islamic banks to serve SMEs more effectively and help increase market penetration.

### *5.6. Risk Management*

**Adopt better and more sophisticated methodologies:** Most financial institutions rely on traditional banking approaches to identify and target viable SMEs. Financial institutions need to incorporate appropriate credit evaluation techniques (such as behavioral scoring, credit scoring, and cash flow and program-based lending) and build stronger early warning systems and collections frameworks to target and manage SMEs better, price products more effectively, and reduce risk exposure.

Streamline loan application processes for SMEs: SMEs facedifficulty in applying for loans due to the amount of documentationrequired and the long approval process (exceeding more than amonth). Most SMEs lack the documentation required to applyfor a loan. The financial requirements of SMEs are urgentcompared with those of large-scale corporate enterprises. As aresult, the approval process must be shortened. Islamic banksneed to streamline processes and focus on building relationships with SMEs (existing and prospective customers), which wouldensure quick delivery of credit.

In order to acquire the required competencies for sustainable, profitable, and high performing Islamic SME portfolio, banks may need to seek technical assistance. SME banking is a line of expertise hardly available in the MENA region and banks in Pakistan have not been able to champion this segment owing to lack of understanding of SME banking disciplines, best business and risk management practices.

## Notes

<sup>i</sup> Simon Bell, Small and Medium Enterprises (SMEs) Finance. [[Retrieved from](#)].

<sup>ii</sup> Hisham Wyne, How Islamic finance plugs SME fund gap. [[Retrieved from](#)].

<sup>iii</sup> Abayomi A. Alawode and Zamir Iqbal, Islamic Finance. [[Retrieved from](#)].

<sup>iv</sup> [[Retrieved from](#)].

<sup>v</sup> Christine Lagarde, Unlocking the Promise of Islamic Finance, Speech by Christine Lagarde, Managing Director, International Monetary Fund at the Islamic Finance Conference, Kuwait City, Kuwait; November 11, 2015. [[Retrieved from](#)].

<sup>vi</sup> Christine Lagarde, Unlocking the Promise of Islamic Finance, Speech by Christine Lagarde, Managing Director, International Monetary Fund at the Islamic Finance Conference, Kuwait City, Kuwait; November 11, 2015. [[Retrieved from](#)].

<sup>vii</sup> [[Retrieved from](#)].

<sup>viii</sup> Christine Lagarde, Unlocking the Promise of Islamic Finance, Speech by Christine Lagarde, Managing Director, International Monetary Fund at the Islamic Finance Conference, Kuwait City, Kuwait; November 11, 2015. [[Retrieved from](#)].

<sup>ix</sup> IFC, Islamic Banking Opportunities across Small and Medium Enterprises. [[Retrieved from](#)].

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